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THE TAX COURT OF THE UNITED STATES

JOSEPH KANE, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Docket No. 50587 Docket No. 52755
ROSE KANE, *Petitioner,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Docket No. 52756

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto by their respective counsel, that the following facts shall be taken as true, provided, however, that this stipulation shall be without prejudice to the rights of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be taken as true.

1. Petitioners, Rose Kane and Joseph Kane, resided at Avondale, Cincinnati, Ohio, until May 1944.

2. In August 1944, Joseph Kane was employed by Bulova Watch Co. Inc. as Assistant to the President, John H. Ballard, for a period of three years at a starting salary of $400 per week, increased by $100 per week in each of the next two years, plus a percentage of the net profits. A copy of the employment contract is attached as Exhibit 1-A.

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3. Joseph Kane's place of employment with Bulova Watch Co. Inc. was in New York, N. Y. The contents of

NOTE: TCR Refers to Tax Court page as certified to U. S. Court of Appeals.

petitioner's home at Cincinnati, Ohio, was sold at auction in May, 1944.

4. On August 17, Arde Bulova addressed a letter to Rose Kane, a copy of which is attached as Exhibit 2-B.

5. The option price in Exhibit 2-B was in excess of the market price at the time the option was granted.

6. The Common Stock of Bulova Watch Co. Inc. was split two for one on July 24, 1945.

7. In accordance with the option agreement, Arde Bulova caused to be transferred 600 shares (stock split 2 for 1) of Bulova Watch Co. Inc. Common Stock on December 27, 1945 for $11,100, 600 shares on August 6, 1946 for $11,100, and 800 shares on July 21, 1947 for $14,800. The market values on the respective dates the options were exercised was $22,300, $30,750 and $27,000. The certificates of stock were issued to Rose Kane.

8. Checks, photostatic copies of which are attached as Exhibits 3-C, 4-D and 5-E, to Arde Bulova for $11,100, $11,100 and $14,800 were drawn by Rose Kane on a checking account in her own name.

9. Rose Kane was not employed by Arde Bulova, or Bulova Watch Co. Inc. at the time she received the options or at any time subsequent thereto.

10. Arde Bulova reported the sales of Bulova Watch Co. Inc. stock to Rose Kane as capital transactions and did not claim deductions for the excess of the market price at the time the options were exercised over the amounts received.

11. No stock options had been issued up to March 31, 1947, by the Bulova Watch Co. Inc. or Arde Bulova, to any employees of Bulova Watch Co. Inc. TCR-103

12. The authorized and outstanding capital stock of Bulova Watch Co. Inc. at March 31, 1945, 1946 and 1947 was as follows:

	Authorized	Outstanding
March 31, 1945	500,000 shs.	324,881 shs.
March 31, 1946	1,000,000 "	649,762 "
March 31, 1947	1,000,000 "	649,762 "

13. During the years involved in this proceeding Arde Bulova owned between 16% and 19% of the capital stock of Bulova Watch Co. Inc. The shares owned by the next largest stockholder was 3.16%.

14. Rose Kane and Joseph Kane filed separate individual Federal income tax returns for 1945, 1946 and 1947.

SIDNEY GELFAND
Counsel for Petitioner

JOHN POTTS BARNES
Chief Counsel
Internal Revenue Service

May 4, 1955

STATUTES, REGULATIONS AND RULINGS INVOLVED

Pertinent provisions of the U. S. Internal Revenue Code of 1939 adopted by Act of February 10, 1939, Chap. 2, 53 Stat. 1-504 applicable to this proceeding are:

Section 22(a) Gross Income

General Definition—"Gross Income" includes gains, profits and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, of any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) Exclusions from Gross Income.

The following items shall not be included in gross income and shall be exempt from taxation under this chapter.

(3) Gifts, bequests, devises and inheritances.

The value of property acquired by gift, bequest, devise or inheritance.

There shall not be excluded from gross income under this paragraph, the income from such property, or, in case the gift, bequest, devise, or inheritance is of income from property, the amount of such income. For the purpose of this paragraph, if, under the terms of the gift, bequest, devise, or inheritance, payment, crediting or distribution thereof is to be made at intervals, to the extent that it is paid

or credited or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property;"

REGULATION 111

Section 29.22(a)-1 (Original Oct. 26, 1943).

What included in gross income.—

Gross Income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See Sections 22(b) and 116). In general, income is the gain derived from capital, from labor, or from both combined provided it be understood to include profit gained through a sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by Sections 211 to 237, inclusive, and in certain cases, by Section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or of property.

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the prop-

erty, increased by the amount of such difference included in gross income. This paragraph does not apply, however, to the issuance by a corporation to its shareholders of the right to subscribe to its stock as to which see Section 29.22(a)-8. * * *

Section 29.22(a)-1: 1946-8-12295

What included in gross income. I.T. 3795

Also Section 23(a), Section 29.23(a)-6;
Section 23(e), Section 29.23(e)-1.

INTERNAL REVENUE CODE

Treatment for Federal Income tax purposes of the granting to an employee of an option to purchase stock of the employer corporation, or an affiliate of the employer corporation, and the subsequent exercise, transfer or lapse of such an option.

Advice has been requested as to the income tax consequences which attach to the granting to an employee of an option to purchase stock of the employer corporation, or of an affiliate of the employer corporation as set forth in Section 141(d) of the Internal Revenue Code, and the subsequent exercise, transfer, or lapse of such an option.

Section 22(a) of the Internal Revenue Code includes in an employee's taxable income any economic or financial benefit conferred on him as compensation, whatever the form or mode by which it is effected. (See Commissioner v. John H. Smith, 324 U. S., 177, Ct. D. 1633, C. B. 1945, 49; Old Colony Trust Co. v. Commissioner, 279 U. S., 716, Ct. D. 80, C. B. VII-2,222). (1929)

Section 29.22(a)-1 of Regulations 111, as amended by Treasury Decision 5507, approved April 12, 1946, applies to options granted to employees on or after February 26, 1945, the date of the Supreme Court's decision in Commissioner v. John H. Smith, supra, and provides in part as follows:

> If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.

In view of the foregoing, if an employee receives an option on or after February 26, 1945, to purchase stock of the employer corporation, or of an affiliate of the employer corporation as set forth in Section 141(d) of the Internal Revenue Code, and the employee exercises such option, the employee realizes taxable income by way of compensation on the date upon which he receives the stock to the extent of the difference between the fair market value of the stock when it is received and the price paid therefor.

If the employee transfers such option for consideration in an arm's length transaction, the employee realizes taxable income by way of compensation on the date he receives such consideration to the extent of the value of such consideration.

If the employee transfers such option in a transaction other than at arm's length and the transferee thereafter exercises the option, the employee realizes taxable income by way of compensation on the date upon which the transferee receives the stock to the extent of the difference between the fair market value of the stock at that time and the price paid therefor less the value of any consideration previously received by the employee for the transfer of the option, which latter value is taxable when received by the employee.

No deduction is allowed to the employee by reason of the lapse of such option except to the extent of any consideration in money or property previously paid by the employee for the option and not recovered by him,

such unrecovered consideration being deductible, pursuant to Section 23(e) of the Internal Revenue Code, in the year in which the option expires.

If such option is granted to the employee by the employer corporation, the amount of compensation realized by the employee under the foregoing principles is deductible by the employer corporation, in the year in which the employee realizes such compensation, to the extent set forth in Section 23(a)(1) of the Internal Revenue Code.

Treasury Decision 5507, supra, does not apply to the case of the exercise or transfer, at whatever date, of an option which was granted to an employee prior to February 26, 1945, to purchase stock of the employer corporation, or of an affiliate of the employer corporation as set forth in Section 141(d) of the Internal Revenue Code.

Accordingly, in view of the prior development of the regulations and interpretations relative to employee stock options (see T.D. 3435, C.B. II-1, 50 (1923); I.T. 3204, C.B. 1938-2, 126; T.D. 4879, C.B. 1939-1 (Part 1), 159), as respects an option granted to an employee prior to February 26, 1945, unless at the time such option was granted there was a substantial difference between the fair market value of the stock and the option price therefor, or, within the purview of Section 29.22(a)-1 of Regulations 111 prior to the amendments made by Treasury Decision 5507, supra, the employee would otherwise clearly realize income by way of compensation through the exercise or transfer of the option, this office will hold that the exercise or transfer of such option, as the case may be, does not result in income to the employee by way of compensation under the principles enunciated in the preceding paragraphs, provided, however, that on or before July 1, 1946, the employee to whom such option is granted and any transferee thereof, and the employer corporation or any other taxpayer who granted such option to the employee, file in duplicate with the Commissioner of Internal Revenue at Washington, D. C., written consents (1) agreeing that the basis to the employee,

and to any transferee of the option, for the stock acquired or to be acquired pursuant to the option shall be the actual price paid therefor and that no deduction shall at any time be claimed attributable to any aspect of the option arrangement, under Section 23(a)(1) or any other subsection of the Internal Revenue Code, by the employer corporation or the taxpayer who granted the option, and (2) indemnifying the Commissioner against the filing of a claim for credit or refund, or any other action by any taxpayer concerned, inconsistent with the consents filed.

For purposes of the preceding paragraph, in determining what constitutes a substantial difference between the fair market value of the stock and the option price in any particular case, consideration will be given, among other things, to the number of shares subject to the option, to the previous variations in fair market value of the stock, and to the type of business and history of the employer corporation and its affiliates.

JOSEPH D. NUNAN, JR.
Commissioner of
Internal Revenue

Approved April 12, 1946
JOSEPH J. O'CONNELL, JR.
Acting Secretary of
the Treasury